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REPORT TO THE CITIZENS' EQUAL OPPORTUNITY COMMISSION

PROPOSAL TO CHANGE CITY'S STANDARD CONTRACT LANGUAGE TO REQUIRE CONTRACTORS TO MAKE PROMPT PAYMENTS TO SUBCONTRACTORS

INTRODUCTION

The Citizens' Equal Opportunity Commission [CEOC] for several years has received complaints from disadvantaged business owners who have served as subcontractors on City construction contracts that they are not receiving prompt payments from contractors following the City's payment to the contractors for work actually performed by the subcontractors. In an attempt to address these complaints, the CEOC has recommended among other things that the City impose a duty on contractors to make prompt payments to their subcontractors and to make that duty clear in its contracts. At the CEOC meeting on January 8, 2003, City staff proposed adoption of new contract language imposing such a duty on City contractors. The proposal is

attached as Exhibit A to this report. This report examines the proposed contract language and outlines major legal issues raised by the language.

I. SUMMARY OF PROPOSED CONTRACT CHANGES

A. Duty Imposed on City Contractors to Pay First Tier Subcontractors and Also on First Tier Subcontractors to Pay Second Tier Subcontractors within Certain Time Limits

This proposed contract language imposes a duty on a contractor to pay a first tier subcontractor within ten days after the contractor's receipt of the City's progress payment. Somewhat less clearly, it also imposes a duty on a first tier subcontractor to pay a second tier subcontractor presumably within ten days after the first tier subcontractor gets paid by the contractor. For

purposes of this report, all duties placed on a "contractor" and sanctions for failure to perform those duties also apply to first tier subcontractors, unless otherwise stated.

B. Two Exceptions to this Duty: Contrary Agreements and Good Faith Disputes

There are a couple of exceptions to this duty expressed in the contract language. First, the duty is not imposed if there is an agreement that says otherwise between the contractor and the first tier subcontractor, or between the first tier subcontractor and the second tier subcontractor. Second, the contractor's payment to the first tier subcontractor is not required when there is a good faith dispute as described in the contract provisions. Presumably, that is also true when there is a good faith dispute between the first tier subcontractor and the second tier subcontractor.

A first tier subcontractor's alleged performance deficiencies is the only kind of good faith dispute that is recognized for purposes of delaying the contractor's payment to a first tier subcontractor. Presumably, again, that is the only kind of good faith dispute recognized between first and second tier subcontractors. In either case, if such a dispute exists, the contractor is required to give written notice to the first tier subcontractor of any withheld amount and to send a copy of that written notice to the City's Contract Administrator at an address indicated in the contract. The required contents for the notice are also contained in the contract provisions, which include: (1) a statement of the amount withheld; (2) a statement of the specific causes for withholding the payment under the terms of the subcontract; (3) a statement of the justification for the amount withheld; and (4) the proposed remedial actions to be taken by the first tier subcontractor to receive payment of the amount withheld.

The contract does not specify who should determine whether a dispute between a contractor and first tier subcontractor, or between a first and second tier subcontractor, is made in good faith or not: Is it the contractor? One of the subcontractors? The City? Or is that to be determined through a hearings procedure? Significantly, the proposed contract language also does not specify what should happen if there is a continued good faith dispute over factual issues, for example, over alleged deficiencies in a subcontractor's work or over the amount withheld.

The proposed contract language then provides that the contractor is required to pay the first tier subcontractor the amount previously withheld[1] within ten calendar days after the first tier subcontractor's deficiency is corrected. Again, presumably, the same is true after a second tier subcontractor's deficiency that is the basis of a dispute between a first and second tier subcontractor is corrected.

C. Sanctions to Be Imposed By City against a Contractor Who Violates These Contract Provisions

[1] Withholding of payments is only one of the sanctions to be potentially imposed on a contractor for failure to pay subcontractors in a timely fashion. This and other sanctions are discussed more fully below. The focus of the discussion in this section of the report is on the effect of a dispute over a subcontractor's right to payment.

If a contractor fails to pay a first tier subcontractor in the time required under these contract provisions, the proposed contract language states that the contractor may be subject to one or more sanctions to be imposed by the City, over and above those sanctions that are currently imposed by law on contractors. The same sanctions would also presumably apply to first tier subcontractors who fail to pay their subcontractors in the time required.

The proposed contract language states that one or more of the following sanctions could be imposed on a contractor for failure to make prompt payments to first tier subcontractors as required by these contract provisions:

(1) Withholding the contractor's future progress payments until final resolution of the matter.

(2) Imposing a fine on the contractor in the amount of two percent per month of the amount due to the first tier subcontractor for every month the payment is not made.

(3) Debarment of a contractor.

The proposed language states that the provisions are not intended to curtail or impair any contractual, statutory, administrative, or judicial remedies available either (a) to a contractor in the event of a dispute involving a first tier subcontractor's deficient performance or nonperformance; or, (b) to a first tier subcontractor in the event of a dispute involving a contractor's late payment or nonpayment.

D. Proposed Language Patterned After California Business and Professions Code Section 7108.5

The proposed language is loosely patterned after section 7108.5 of the California Business and Professions Code and related California Public Contract Code sections, copies of which are attached as Exhibit B to this report. The California Department of Transportation includes a "prompt progress payments to subcontractors" clause in their contracts, which cautions contractors to refer to California Business and Professions Code section 7108.5 and other California Code sections spelled out in Exhibit B.[2]

In contrast with the three penalties against contractors who fail to make the required prompt payment to subcontractors proposed for inclusion in City contracts, California Business and Professions Code section 7108.5 provides two penalties for contractors (or subcontractors) who violate the prompt payment provisions of the statute: (1) a violation will constitute a cause for disciplinary action against the contractor's license and (2) a violation will subject the licensee to a penalty, payable to the subcontractor, of two percent of the amount due per month for every month that payment is not made.

Significantly, there is no provision in this statute for withholding future progress payments to the contractor for failure to make prompt payments to the subcontractors.

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[2] Information received from Don Scheel, Chief, Office of Construction Contract Standards, Division of Engineering Services-Office Engineer, California Department of Transportation, via e-mail on February 4, 2003.

II. RELATIONSHIP TO CURRENT STATE LAW REQUIRING PROMPT PROGRESS PAYMENTS AND PROMPT PAYMENTS FROM RETENTION PROCEEDS TO CONTRACTORS

One of the major legal issues raised by the proposed contract language, particularly the proposed sanction of withholding of payments, is whether it is preempted by California Public Contract Code section 20104.50 requiring local governments to make prompt progress payments to its contractors or by California Public Contract Code section 7107 regarding the timing of final payments and release of retention monies to contractors. These preemption issues are discussed below**.**

A. Prompt Progress Payments and California Public Contract Code Section 20104.50

The above-described proposed contract provisions, among other things, would require the City to withhold future progress payments to a contractor if the contractor has failed to pay his or her first tier subcontractors in the time required by the contract (that is, ten days from contractor's receipt of the City's progress payment for work the subcontractor did). This requirement to withhold future progress payments raises questions under state law requiring cities to pay their contractors promptly. Cal. Pub. Contr. Code § 20104.50.

On its face, section 20104.50 of the California Public Contract Code requires local governments in California to pay a contractor on a construction contract within thirty days of the local government's receipt of an undisputed and properly submitted payment request from the contractor. A local government's failure to make “prompt” progress payments to its contractor under this statute subjects the local government to a requirement to pay interest to the contractor at the rate set by section 685.010 of the California Code of Civil Procedure (currently 10%).

As a practical matter, two of the major City departments that handle public works contracts, the Engineering and Capital Projects Department [E&CP] and the Water Department [Water], both of which most often deal with solely municipal projects and almost exclusively use municipal funds, do not currently follow this California Public Contract Code section. Instead, E&CP relies on Section 9-3 of the Standard Specifications for Public Works Construction (2000 Edition) [Greenbook] and its Regional and City Supplements for determining when and how to make progress payments to City contractors. The Greenbook does not contain a prompt payment provision. Water uses section 9-3 of the Greenbook, but modifies it by including prompt payment provisions that are similar to, but not identical with, California Public Contract Code section. 20104.50. However, the City's Metropolitan Wastewater Department, which most often handles contracts that are not considered solely municipal projects and often uses a mix of regional, state and federal monies, routinely follows California Public Contract Code section 20104.50 and inserts appropriate implementing language into its contracts.

California Public Contract Code section 20104.50 purportedly applies to all types of public works contracts let by local governments, including those traditionally considered to be of solely municipal concern, according to the express statement of legislative intent in section 20104.50(a)(1) and (2):

> (1) It is the intent of the Legislature in enacting this section to require all local governments to pay their contractors on time so that these contractors can meet their own obligations. In requiring prompt payment by all local governments, the Legislature hereby finds and declares that the prompt payment of outstanding receipts is not merely a municipal affair, but is, instead, a matter of statewide concern.
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> (2) It is the intent of the Legislature in enacting this article to fully occupy the field of public policy relating to the prompt payment of local governments' outstanding receipts. The Legislature finds and declares that all government officials, including those in local government, must set a standard of prompt payment that any business in the private sector which may contract for services should look towards for guidance.

Though the State Legislature has declared that the time frame in which cities, including charter cities such as San Diego, pay their public works contractors is a statewide issue and, therefore, subject to statewide legislation, a declaration to that effect does not necessarily render a municipal affair a statewide issue. The City Attorney fully analyzed the preemption issue as it relates to municipal contracts funded by local monies recently and concluded that, absent a judicial finding, the state Legislature's attempts by mere declaration to convert a charter city's municipal contract into a matter of statewide concern is ineffective. City Att'y MOL No. 2001-26 (Dec. 14, 2001).Without repeating that analysis, we conclude that, in adopting California Public Contract Code section 20104.50, the state Legislature has once again attempted to convert a purely municipal matter into a statewide issue by mere declaration. It is ineffective for purposes of obliging this City to follow California Public Contract Code section 20104.50 for municipally funded local projects.

B. Prompt Payments from Retention Proceeds and California Public Contract Code Section 7107

Section 7107 of the California Public Contract Code, which deals with release of retention proceeds to contractors and payment of subcontractors, states that it applies to all contracts relating to the construction of any public work of improvement. Cal. Pub. Contr. Code § 7107(a). California Public Contract Code section 7107 requires payment of undisputed retention amounts to the contractor within 60 days from “completion” of a job. The date of completion is defined as one of four different events, which may occur at different times. If the retention payments are not made within the time required, the public entity may be subject to a charge of two percent per month on any improperly withheld amount. Cal. Pub. Contr. Code § 7107(f). In addition, in any action for the collection of funds wrongfully withheld, the prevailing party is entitled to attorney's fees and costs. Cal. Pub. Contr. Code § 7107(f).

Section 1100.7 of the California Public Contract Code states that all portions of the Public Contract Code apply to charter cities unless specifically exempted from its application by ordinance or charter. Although the City Council has by ordinance declared the City's Public Contracts Code (as defined elsewhere in the ordinance) or any portion thereof is expressly

exempt from the California Public Contract Code (SDMC § 22.3002(a)), the Council also stated that the City in its discretion may follow portions of the California Public Contract Code (SDMC § 22.3002(b)).

The City's Metropolitan Wastewater Department, again because its contracts deal primarily with regional projects, follows California Public Contract Code section 7107 for the timing of the final payment and release of retention monies to the contractor. However, the City's E&CP and Water Departments do not. Instead, their contracts require the City to make the final payment and release undisputed retention monies to contractors within thirty-five days after the notice of completion is recorded with the County of San Diego. In practice, much of the time the City's Water and E&CP final payment schedule and release of retention monies fall within the time lines required by California Public Contract Code section 7107.

To date the City has not been successfully challenged in a court of law on a preemption theory on its ability as a charter city to have final payment and release of retention monies provisions in its municipal project contracts that differ from the final payment and release of retention monies provisions in California Public Contract Code section 7107. We note that California Public Contract section 7107 governing final payments to contractors does not contain the strong statement of legislative intent to preempt local law that is contained in California Public Contract Code section 20104.50 governing progress payments to contractors.

III. RELATIONSHIP TO CURRENT STOP NOTICE LAWS

Another major legal issue posed by the contract language is whether it impermissibly conflicts with the state's stop notice process.

One of the primary legal remedies currently available to subcontractors who believe they have not been paid by a public works contractor is the detailed stop notice claim procedure located in California Civil Code sections 3179 – 3214. Under this procedure, if a subcontractor has filed a valid claim, has followed the required statutory procedures, and has met the strict statutory deadlines, the subcontractor will be entitled to his or her pro rata share of monies that have been retained by the government entity holding the original contract. Cal. Civ. Code § 3190. Significantly, no matter when a subcontractor's work was performed on a job, a subcontractor will not receive his or her money from an undisputed valid claim until after the local government has filed a notice of completion on the entire job (Cal. Civ. Code § 3184), which may take several months or even years after a subcontractor has performed his or her work on a particular public works job.

This sometimes lengthy delay in payment to subcontractors who avail themselves of the stop notice procedure is one of the reasons for subcontractors' complaints to the CEOC.[3]

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[3] By adopting the contract language proposed by City staff, the City arguably would be relieving its subcontractors from the burden of having to comply with the strict time lines and procedures of the stop notice laws to get paid. At the same time, the City would be obliged by this contract language to take an active role not only in monitoring its contractors' payments to first tier subcontractors, but also first tier subcontractors' payments to second

Although a subcontractor on a public works job has other remedies against the contractor or the contractor's bonding company to recover monies owed to him by the contractor, currently the sole avenue for a subcontractor to recover monies allegedly owed to him or her by the public works contractor, but held by the public entity, is to use the stop notice procedure. Because withholding a contractor's money that has already been earned by that contractor is a drastic legal measure, the elaborate stop notice procedure established by the state, which has been designed to protect all parties to the dispute, is arguably the sole legal mechanism recognized and authorized by state law and now available to the City to withhold monies from contractors to pay first and second subcontractors.

There are certain aspects of the stop notice procedure that are worthy of attention at this juncture. First, we point out that even if the City were to adopt the proposed prompt payment contract language, including the sanctions as proposed, the prompt payment language would not replace the stop notice procedure. Rather, the prompt payment provisions in the City's contracts would be an additional remedy to be used by subcontractors to try to get payment from contractors. The stop notice procedure would still be available to them.

Second, from information provided by the City Auditor and Comptroller's Office, we know that the City has received approximately seventy stop notice claims since March 2002. Although the stop notice dispute is between the contractor and a subcontractor, and the City is a mere holder of the money, each of those claims requires several hours to several days for City staff and the City Attorney's office to resolve. Many of them result in some form of litigation to which the City is a party. Because this remedy will not be replaced by the sanctions imposed by the contract language, it is reasonable to assume that subcontractors will continue to file stop notice claims in order to preserve their rights under state statutes. It is far from clear whether the City could anticipate a lesser number of stop notice claims than it currently receives.

Third, even though the stop notice statutes do not specifically address the issue of interest owed to contractors on monies temporarily withheld by a public entity pursuant to a subcontractor's stop notice, case law has addressed this issue.
In a case arising out of Los Angeles, the appellate court held that:

> [T]he Takings Clause of the Fifth Amendment of the United States Constitution, applied to the states through the Fourteenth Amendment, and the California common law as well, bar a public entity from retaining for its own account interest earned by funds the entity withheld from a prime contractor pursuant to a subcontractor's stop notice.

Breda Costruzioni Ferroviarie S.P.A. v. Los Angeles County Metropolitan Transportation Authority, 56 Cal. App.4th 1433 (1997). However, the court also held that the entity had to pay only the interest actually earned on the withheld fund, not the statutory interest rate. *Id.* at 1440. This ruling is significant because the interest actually earned on monies withheld by a government is often less than the statutory rate.

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tier subcontractors to ensure that first and second tier subcontractors were paid on undisputed claims shortly after they performed the work.

IV. CITY'S AUTHORITY TO IMPOSE FINES ON CONTRACTORS WHO FAIL TO MAKE PROMPT PAYMENTS TO FIRST TIER SUBCONTRACTORS AND ON FIRST TIER SUBCONTRACTORS WHO FAIL TO MAKE PAYMENTS TO SECOND TIER SUBCONTRACTORS

Another major legal issue raised by the proposed contract language is whether the City has authority to impose fines on a contractor or a subcontractor through a contract provision. One of the proposed sanctions [penalties] in this contract language would impose a fine in the amount of two percent per month of the amount due the subcontractor for every month the payment to the subcontractor is not made by the contractor (or the payment to the second tier subcontractor is not made by the first tier subcontractor). The contract language does not specify to whom the fine shall be paid. Presumably the fine would be payable to the City. It is not clear whether the City would then turn all or part of it over to the complaining subcontractors.

The City Council, as the legislative body of a charter city, has authority to adopt ordinances that impose civil penalties or fines on violators of the City's laws. See City Att'y MOL No. 87-9 (Feb. 3, 1987). This City Council has in fact adopted ordinances that impose civil penalties for violation of the City's laws. See, for example, San Diego Municipal Code [SDMC] sections 12.0801 – 12.0810 (Administrative Civil Penalties) and sections 12.0901 – 12.0910 (Administrative Citations).

The law is not clear on whether that authority extends to the City Manager to adopt contract language that imposes penalties on contractors and subcontractors who fail to make prompt payments to their subcontractors without Council's express authorization.

V. FAILURE OF CONTRACTOR TO MAKE PROMPT PAYMENT TO SUBCONTRACTOR AS GROUNDS FOR DEBARMENT

Another legal issue raised by this language is whether the City's current debarment ordinance needs to be amended. Under the proposed contract language, one of the possible sanctions to be imposed on a contractor for failure to promptly pay his or her subcontractors is debarment from City contracting. The proposed contract language leaves open the question of how long a debarment period should apply for a contractor's failure to make a prompt payment as required by this contract language.

Under the City's current debarment laws, a contractor's unjustifiable failure to meet the City's contractual obligations is already grounds for debarment. SDMC § 22.0807(d)(4). Failure to meet a contractual obligation in one instance is grounds for debarment for no less than three years. SDMC § 22.0807(e). Failure to meet a contractual obligation in two or more instances is grounds for debarment for no less than three years and in some cases up to permanent debarment. SDMC § 22.0807(d). The current debarment ordinance already applies to both contractors and first and second tier subcontractors. SDMC § 22.0802 (definition of “debar” or “debarment”). Therefore, the current debarment ordinance probably does not have to be amended if the intended debarment period for failure to make prompt payment corresponds to existing

provisions of the debarment ordinance. However, the contract language should be rewritten to clarify the intended time period for debarment for violations of the prompt payment provisions.

VI. CREATION OF THIRD PARTY BENEFICIARY CONTRACT IN FAVOR OF FIRST AND SECOND TIER SUBCONTRACTORS

One of the most important legal issues raised by this contract language is that it may create rights in first and second tier subcontractors to sue the City as third party beneficiaries to enforce provisions in the City's public works contracts. Under current law and City contracts, those persons do not have that right.

California Civil Code section 1559 states that a contract made expressly for the benefit of a third person may be enforced by that person any time before the parties to the contract rescind it. As interpreted by the courts, mere incidental beneficiaries of a contract are not entitled to sue to enforce the contract. *Bancomer, S.A. v. Superior Court*, 44 Cal. App. 4th 1450; 1458-59 (1996). Under current law, a first tier contractor who is listed in a contractor's bid on a public works contract as required by California Public Contract Code section 4107 (part of the Subletting and Fair Practices Act in the Public Contract Code) is considered an incidental beneficiary and therefore not entitled to sue the public entity to enforce the contract. *Southern California Acoustics Co. v. C. V. Holder, Inc.,* 71 Cal.2d 719; 727-28 (1969).

As shown above, the proposed contract language imposes a duty on City contractors to pay their subcontractors' undisputed claims within ten days after the City pays its contractor (and imposes a duty on first tier subcontractors to promptly pay the second tier subcontractors, presumably within ten days after the first tier subcontractor is paid by the subcontractor — although this is not clear in the contract language). According to this contract language, failure to make prompt payment will result in one or more penalties against the contractor. Among those penalties is the possibility of the City's withholding money from future progress payments owed to the contractor for work done by a subcontractor for ultimate payment to the subcontractor.

If the proposed contract language is adopted and inserted into City contracts, the language may create a right in first and even second tier subcontractors to sue the City to enforce its contracts. See, for example, *Ralph C. Sutro Co. v. Paramount Plastering, Inc.,* 216 Cal. App. 2d 433 (1963) (a construction loan agreement that said that a builder-borrower was not to receive payment of the last installment of the loan proceeds except on a showing that all claims for labor and material had been paid was held by the court to create an agreement for the benefit of the subcontractors of the owner-builder and enforceable by them).

VII. HEARING FOR IMPOSITION OF SANCTIONS ON CONTRACTORS AND SUBCONTRACTORS

Another important issue raised by the proposed contract language is the number and kind of administrative hearings that the City will be required to hold if the language is implemented. As proposed, before any sanction is imposed on a contractor, the contract would require that the City offer the contractor an opportunity to be heard in front of a hearing officer or body. Again,

presumably, this same offer must to made to any first tier subcontractor before any sanctions are imposed on him or her. The City Attorney believes that a meaningful hearing is required by constitutional due process principles, because the sanctions are to be imposed on a person who will have earned the right to payment under the City's contract and therefore has a property right at stake.

The contract does not specify the necessary elements of the hearing. However, case law establishes that for a due process hearing to be meaningful, the hearing must be held by, and the decision must be made by, a fair and impartial hearing officer or body. *Haas v. County of San Bernardino*, 27 Cal.4th 1017, 1024 (2002).

If the sanction chosen by the City is debarment, the City's existing debarment ordinance contains a hearing procedure that passes constitutional muster and would be used to make the determination. If either of the other two sanctions were chosen, the City should amend its ordinances to apply a preexisting hearing procedure to govern them. Given the number of City contracts outstanding at any one time and the severity of the sanctions, it is reasonable to anticipate that the City will receive at least as many if not more claims and requests for hearings under this contract language than it currently receives in stop notice claims. (Recall that the City received seventy stop notice claims in the past calendar year. See page 8, above.) Each one of those claims could result in one or more hearings.

VIII. NEED FOR CLARIFICATION AND PRACTICAL CONSIDERATIONS

We recommend that the Commission clarify the intent of the proposal and direct the City Attorney to return with a revised draft reflecting that clarified intention, as follows:

(1) Clarify whether it is the intention to require first tier subcontractors to pay their (second tier) subcontractors promptly.

(2) Clarify what event will trigger the payment due date to a second tier subcontractor, which is presumably not the date the City pays the first tier subcontractor. Will it be ten days from the date the contractor pays the first tier subcontractor? What effect will there be on the payment due date for a second tier subcontractor if there is a dispute involving a hearing on the contractor's payment to the first tier subcontractor?

(3) Clarify the mechanisms to be used to monitor percentage of progress payments owed to first and second tier contractors. Will the City impose different invoicing procedures on contractors and on first tier subcontractors? Will the City's field division engineers be expected to make the determination? Clarify what is to happen if there is a discrepancy between a contractor's invoice and the field engineer's observations.

(4) Clarify who is to determine whether a dispute is made in good faith. Should it be the contractor? The City? A hearing officer?

(5) Clarify whether all or only part of a progress payment is to be withheld if there is a claim that a subcontractor has not been paid. Clarify whether a progress payment to the contractor is to be withheld if the prompt payment dispute is only between the first and second tier subcontractor, not between the first tier subcontractor and the contractor.

(6) Clarify whether the two percent fine per month is to be levied against all of a progress payment or only that part which is in dispute. Clarify whether the two percent fine is to be levied on the contractor and the money withheld from the contractor's payment if the prompt payment dispute is only between the first and second tier subcontractor, not between the first tier subcontractor and the contractor.

CONCLUSION AND RECOMMENDATION

Given the significance and number of legal and policy issues that are raised by the proposed changes to the City's standard contract language, the City Attorney recommends that the proposal be returned to staff to work with the Attorney's office to resolve the outstanding issues.

Respectfully submitted,

CASEY GWINN
City Attorney

CCM:sc
RC-2003-10
Attachments: Exhibit A (Proposed Contract Language Draft)
Exhibit B (California Business and Professions Code section 7108.5 and related sections)

cc: P. Lamont Ewell, Assistant City Manager
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